SUBJECT INDEX.

TABLE OF CASES.

In the Supreme Court of the United States

OCTOBER TERM, 1942.

No.........................

VIRGINIAN HOTEL CORPORATION OF LYNCHBURG,
PETITIONER,

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT.

BRIEF FOR PETITIONER.

OPINIONS BELOW.

The opinion of the United States Board of Tax Appeals (now Tax Court of the United States and hereinafter referred to by that name) rendered May 6, 1942 is a memorandum opinion, and thus is not reported. It is included in the record (R. 34-38). The opinion of the United States Circuit Court of Appeals for the Fourth Circuit rendered January 2, 1943 has not yet been reported, but is included in the record (R. 46-52).

BASIS OF JURISDICTION.

Jurisdiction is invoked under Section 240(a) of the Judicial Code as amended by the Act of February 13, 1925, 43 Stat. 938, 28 U. S. Code Ann. 347.

This case involves income and excess profits taxes for the year 1938 and is taken from the decision of the United States Circuit Court of Appeals for the Fourth Circuit filed January 2, 1943. Application for stay of mandate pending application in this court for writ of certiorari was filed January 27, 1943. An order staying the mandate of said court for thirty days pending the filing of an application for writ of certiorari in this court was entered January 28, 1943 and filed January 29, 1943.

STATEMENT OF CASE.

The facts in this case were stipulated (R. 22-27). The Tax Court of the United States by reference included the facts as stipulated in its finding of facts (R. 34).

The petitioner (hereinafter referred to as the taxpayer) is a Virginia corporation with its principal office in Lynchburg, Virginia. It was incorporated in 1930. Since January 1, 1931 it has operated a hotel in Lynchburg, Virginia. It filed its income tax return for the calendar year 1938 with the Collector of Internal Revenue for the District of Virginia at Richmond, Virginia, and reported thereon a net taxable income of $11,688.90 (R. 22). The taxpayer is the owner of the furniture, fixtures and other equipment used in connection with the operation of its hotel business (R. 23).

On June 1, 1927 A. F. Young and R. E. Young purchased from Virginian Hotel, Inc., the then owner, all of the furniture, fixtures and other equipment used in the operation of said hotel for the sum of $70,899.94. The said A. F. Young and R. E. Young operated the

hotel as partners from June 1, 1927 to December 31, 1930. At that time the partnership was incorporated as the Virginian Hotel Corporation of Lynchburg, the taxpayer herein, and all of its issued capital stock (except qualifying shares) was issued to A. F. Young and R. E. Young for the net book value of the partnership assets. The values of said furniture, fixtures and other equipment remained unchanged after the incorporation since no change in actual ownership was involved. The taxpayer has continuously operated the hotel since January 1, 1931 (R. 23).

The total amount expended by the partnership and the taxpayer for furniture, fixtures and other equipment, including replacements, capitalized from June 1, 1927 to December 31, 1938 is as follows (R. 24):

	Furniture and fixtures	Carpets	Cafe improvements	Laundry equipment	Ice machine	Total
Purchased from prior lessee June 1, 1927	$38,400.20	$19,341.70	$7,232.40	$4,103.21	$1,822.43	$70,899.94
Additions:						
1927	1,730.33	1,254.90	9,599.67			12,584.90
1928	3,087.23	2,745.58	3,894.13	175.00	121.51	10,023.45
1929	692.35	2,395.99	659.08		325.00	4,072.42
1930	1,789.54		214.81			1,997.35
1931	15,035.55	4,406.74	3,057.04	1,011.23	241.65	23,750.21
1932	2,733.92		242.05	2,447.35	33.68	5,457.00
1933					102.96	102.96
1934	999.63		49.86			1,049.49
1935	184.57	814.36				998.93
1936	134.76	686.73	100.00		75.00	996.49
1937	544.85	622.54				1,167.39
1938	3,075.76	2,437.79	915.97		268.44	6,697.96
Total	30,006.49	15,357.63	18,732.61	3,633.58	1,168.24	68,898.55
Grand total	68,406.69	34,699.33	25,965.01	7,736.79	2,990.67	139,798.49

In each of the calendar years ended December 31, 1931 to December 31, 1937 the taxpayer depreciated its furniture, fixtures and other equipment at certain

straight line rates, namely, ten per centum on all of its furniture, fixtures and other equipment, except carpets, and fifteen per centum on its carpets (R. 25). These rates were based upon an estimated useful life of ten years for all of its equipment, except carpets, and six and two-thirds years for its carpets. The depreciation so computed was reported on its income tax returns for each of the aforesaid calendar years and no question was raised by the Commissioner as to the rates at which said assets were depreciated (R. 25).

On its income tax return filed for the calendar year ended December 31, 1938 the taxpayer claimed a deduction for depreciation in the amount of $4.341.97, said depreciation being calculated at the same rates at which depreciation had been calculated in the preceding years (R. 22). The Commissioner then for the first time questioned the amount of the deduction for depreciation and determined that the useful life of the furniture, fixtures and other equipment had been under-estimated and that the rates of depreciation therefore used by the taxpayer were excessive. He then determined that the useful life of the furniture, fixtures and other equipment, except carpets, was twenty years from their date of acquisition and the useful life of the carpets twelve and one-half years from their date of acquisition (R. 25, 16-17). Accordingly he disallowed $3,046.50 of the amount of depreciation claimed by the taxpayer in its return for the year 1938 and allowed a deduction in the amount of $1,295.47 (R. 25). The Commissioner calculated the depreciation by deducting from the cost of the property to the taxpayer the depreciation theretofore reported by it on its income tax returns for prior years and the remainder was taken as the new basis for computing depreciation for the year 1938 and subsequent years. The rate of depreciation was then determined on the basis of what remained of the useful life

of the depreciable property. Thus on a certain item the cost of which was $15,033.55 and which had been in use six and one-half years and upon which depreciation of $9,771.83 had been reported on its prior tax returns, the Commissioner found that there was an undepreciated cost of $5,261.72 with a useful life of thirteen and one-half years and allowed annual depreciation of $389.76 or an amount, which if taken annually for thirteen and one-half years would liquidate the remaining undepreciated costs (R. 25, 16-17).

The partnership had a net gain for each of the years from June 1, 1927 to December 31, 1930, inclusive, and the entire amount of depreciation reported in its returns for those years served to reduce taxable income. The taxpayer sustained a net loss for each of the years 1931 to 1936, both inclusive, and the entire amount of depreciation reported in its returns for those years did not serve to reduce its taxable income. The year 1937 resulted in a net gain and the depreciation reported on the income tax return for that year served to reduce taxable income. Recomputing the depreciation for the years prior to 1938, using the amount reported as a deduction for the years in which the taxpayer reported a net profit, and the amount *allowable,* at the Commissioner's rates as determined for 1938, for the years which resulted in a net loss, the excess depreciation reported by the taxpayer over the amount *allowable* is $31,400.25. This amount did not serve to reduce taxable income. Restoring the amount of $31,400.25 to taxpayer's unexhausted depreciation base as of December 31, 1937, the correct allowable depreciation for the year 1938 applying the Commissioner's rates, is $4,438.14 (R. 25-26). The Tax Court of the United States decided that the taxpayer was entitled to restore to its unexhausted depreciation base as of December 31, 1937 the sum of

$31,400.25. On appeal to the United States Circuit court of Appeals for the Fourth Circuit the decision of the Tax Court was reversed.

ASSIGNED ERRORS.

The essential error of the United States Circuit Court of Appeals for the Fourth Circuit is its holding that the taxpayer is not entitled to restore to the value of its depreciable assets as of December 31, 1937 so much of the depreciation erroneously reported on its tax returns for the years 1931 to 1937, inclusive, as did not reduce its taxable income in the respective years in which reported and is in excess of the allowable depreciation for said respective years. This amount is $31,400.25.

This error arises as a result of the United States Circuit Court of Appeals for the Fourth Circuit holding that depreciation reported on a tax return, even though such depreciation is in excess of the allowable depreciation and does not reduce or offset taxable income for the year in which reported, is allowed within the meaning of Section 113(b)(1)(B) of the Revenue Act of 1938, 52 Stat. 494, solely because of its having been erroneously reported on the tax return.

STATUTES AND REGULATIONS INVOLVED.

Revenue Act of 1938, c. 289, 52 Stat. 447:

"SEC. 23. DEDUCTIONS FROM GROSS INCOME.

"In computing net income there shall be allowed as deductions:

"* * * * *

"(l) *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear of property used in

the trade or business, including a reasonable allowance for obsolescense. * * *

"* * * * *

"(n) *Basis for depreciation and depletion.*—The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be as provided in section 114.

"* * * * *

"SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

"* * * * *

"(b) *Adjusted basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

"(1) *General rule.*—Proper adjustment in respect of the property shall in all cases be made—

"* * * * *

"(B) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescense, amortization, and depletion, to the extent allowed (but not less than the amount allowable) under this Act or prior income tax laws. * * *

"* * * * *

"SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

"(a) *Basis for depreciation.* — The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 113(b) for the purpose of determining the gain upon the sale or other disposition of such property.

"* * * * *"

The applicable regulations are Articles 23(1)-1, 2, 4, 5 and 9, 113(b)-1 and 114-1 of Treasury Regulations 101, relating to the Revenue Act of 1938.

SUMMARY OF ARGUMENT.

The decision of the United States Circuit Court of Appeals for the Fourth Circuit is unsound. Sections 114(a) and 113(b)(1)(B) of the Revenue Act of 1938 provide that in determining the basis for depreciation proper adjustment shall be made in respect of prior years for depreciation, to the extent *allowed* (but not less than the amount *allowable*) under the Act or prior income tax laws. The decision of the United Circuit Court of Appeals requires the taxpayer to adjust the basis of its depreciable assets not only for the *allowable* depreciation in the prior years, but also for all depreciation reported by it on its tax returns in such prior years even though such reported depreciation is in excess of the *allowable* depreciation and did not off-set or reduce the taxable income of the taxpayer in the years in which reported. This inequitable result was clearly not intended by Congress when it amended Section 113(b)(1)(B) of the Revenue Act of 1932, which provision of the Revenue Act of 1932 is identical with Section 113(b)(1)(B) of the Revenue Act of 1938 and here under consideration.

ARGUMENT.

Proper Construction of the Word "Allowed"

The taxpayer, *in limine,* wishes to call the court's attention to the fact that it depreciated its furniture, fixtures and other equipment for the years 1931 to 1937, inclusive, at certain fixed rates. The depreciation so computed was reported by it as a deduction on each of its income tax returns for the years 1931 to 1937, inclusive, and the amount of depreciation reported as a deduction on said returns was not questioned by the Commissioner. In the year 1938 the taxpayer again depreciated its assets by using the same percentages which it had

used in the preceding mentioned years. The Commissioner of Internal Revenue then for the first time questioned the reasonableness of the rates used by the taxpayer and accordingly determined that the useful life of the taxpayer's depreciable assets had been under-estimated and that the rates used by the taxpayer in computing its depreciation were excessive. He then determined that the useful life of taxpayer's furniture, fixtures and other equipment except carpets was twenty years and the useful life of the carpets twelve and one-half years. From the cost of the said furniture, fixtures and other equipment the depreciation theretofore reported by the taxpayer on its returns was deducted, and the remainder was taken as the new base for computing depreciation. The rate of depreciation was arrived at on the basis of what remained of useful life.

As a result of the Commissioner's actions the taxpayer's allowable depreciation for the year 1938 was reduced from $4,341.97 to $1,295.47. As this action was taken by the Commissioner it can hardly be argued that the taxpayer is not equitably entitled to restore to the value of its depreciable assets as of December 31, 1937 so much of the depreciation reported by it on its income tax returns for the years 1931 to 1937 as did not reduce its taxable income in the respective years in which reported and is in excess of the depreciation which would have been reported by the taxpayer on said returns if it had depreciated its assets according to the rates now determined by the Commissioner as to be reasonable.

The question presented arises under the Revenue Act of 1938, 52 Stat. 447. Section 23(n) of that Act provides that the basis upon which depreciation is to be allowed shall be as provided in Section 114. Section 114(a) of the Act then provides that the basis for depreciation shall be the adjusted basis of said property provided in Section 113(b) for the purpose of determin-

ing the gain upon the sale or other disposition of such property. Section 113(b)(1)(B) provides that in determining such basis, proper adjustment shall be made in respect of any period since February 28, 1913 for depreciation to the extent *allowed* (but not less than the amount *allowable*) under the Act or prior income tax laws.

The taxpayer contends that depreciation is not *allowed* within the meaning of the statute when it is reported by it on an income tax return, but is not used as a deduction on said return because the taxpayer has no net income which is offset thereby. *Pittsburgh Brewing Co.* v. *Commissioner of Internal Revenue* (C. C. A. 3d), 107 F. (2d) 155; *Don Lee, Inc.* v. *United States* (N. D. Cal.), 42 F. Supp. 884; *Kennedy Laundry Co.* v. *Commissioner of Internal Revenue,* 46 B. T. A. 70.

Prior to the Revenue Act of 1924 there was no specific provision with respect to adjustment for depreciation in computing gain or loss from a sale of property. In spite of this fact the courts held that when property is sold the basis thereof must be reduced by the aggregate amount of depreciation which was legally *allowable* in past years. *United States* v. *Ludey,* 274 U. S. 295, 71 L. Ed. 1054; *Hardwick Realty Co.* v. *Commissioner* (C. C. A. 2d), 29 F. (2d) 498. Neither of these two cases decide the precise question here involved. An examination of the case of *United States* v. *Ludey, supra,* discloses, however, that Mr. Justice Brandeis in his opinion at page 304 expressly repudiated the principle here contended for by the respondent when he said:

> " * * * On the other hand, we cannot accept the government's contention that the full amount of depreciation and depletion sustained, whether allowable by law as a deduction from gross income in past years or not, must be deducted from cost in ascertaining gain or loss. Congress doubtless in-

> tended that the deduction to be made from the original cost should be the aggregate amount which the taxpayer was entitled to deduct in the several years."

By Section 202(b) of the Revenue Act of 1924 it was provided that in computing gain or loss, adjustment should be made for depreciation previously *allowed.* The word *allowed* as used in this section of the Revenue Act of 1924 seems never to have been judicially construed. Section 202(b) of the Revenue Act of 1926 is different in that it provides for diminution of the basis by the amount of the deductions for depreciation which have since the acquisition of the property been *allowable.* That provision is also contained in Section 111(b)(2) of the Revenue Act of 1928. In Section 113(b)(1)(B) of the Revenue Act of 1932 the law was again changed so as to provide for adjustment for depreciation to the extent *allowed* (but not less than the amount *allowable*) under that Act or prior income tax laws. That same provision is contained in all subsequent Revenue Acts, including the statute here involved (Section 113(b)(1)(B) of the Revenue Act of 1938, supra). It is thus clear that this court has only to determine why Congress used the word *allowed* in Section 113(b)(1)(B) of the Revenue Act of 1932 and then construe said section so as to carry out the purpose and intent of Congress. This court in the recent case of ***Harrison* v. *Northern Trust Co. et al.,*** decided January 11, 1943, 87 L. Ed. 320, 322, quite pointedly said, "But words are inexact tools at best and for that reason there is wisely no rule of law forbidding resort to explanatory legislative history no matter how 'clear the words may appear on "superficial examination"' * * * ." An examination of the legislative history of Section 113(b)(1)(B) discloses the reason for the 1932 amendment and thus makes it unnecessary for this court to speculate as to the reason for the amend-

ment. The Senate Report on the Bill states that not infrequently a taxpayer who had *taken* and been *allowed* depreciation deductions at certain rates consistently over a period of years would later, when he found it to his advantage so to do, claim that the allowances so made to him were excessive and that the amounts which were in fact *allowable* were much less. Not infrequently the taxpayer would not make such a contention until the government would be barred from collecting the additional taxes which would be due for the prior years if the taxpayer's contentions were upheld. While Congress was of the opinion that the law then in force did not countenance any such inequitable results, it was of the opinion that the new law should preclude any such possibility.[1] The Senate Report leaves no doubt but that the amendment was to apply only to those cases in which a deduction for depreciation has been both *taken* and *allowed,* that is, the deduction must be taken on the return and it must also offset or reduce taxable income. The construction of the law here contended for by the taxpayer also carries out the declared purpose of Congress to prevent a taxpayer, who has had the *benefit* of a larger depreciation deduction from gross income than was properly *allowable* to him, from claiming upon the sale of the depreciated property that his sales basis should be increased by deducting only the smaller depreciation properly allowable, thus gaining a double deduction against taxable income. No such double deduction can be obtained by the taxpayer in this case as

[1]See S. Rep. No. 665, 72d Cong., 1st Sess., p. 29 (1939-1 Cum Bull. (Part 2) 496, 517), as follows:

"In subparagraph (B), relating to depreciation, etc., for the period since February 28, 1913, the bill requires that adjustment be made 'to the extent allowed (but not less than the amount allowable)' instead of 'by the amount * * * allowable' as in the prior act. The Treasury has frequently encountered cases where a tax-

the stipulated facts show that the taxpayer sustained a net loss for each of the years 1931 to 1936, inclusive, and the entire amount of depreciation deducted on its income tax returns for those years did not serve to reduce its taxable income.

The United States Circuit Court of Appeals for the Third Circuit in the case of *Pittsburgh Brewing Co.* v. *Commissioner of Internal Revenue, supra,* after a careful consideration of the legislative history of Section 113(b)(1)(B) of the Revenue Act of 1932, decided that depreciation is not *allowed* under the statute unless it offsets or reduces taxable income. The court in delivering its opinion in this case at page 156, said:

> "* * * After full consideration of this question we have reached the conclusion that depreciation is not 'allowed' *within the meaning of the Act unless it is actually taken as a deduction against taxable income.*
>
> "Allow is defined as 'To grant (something) as a deduction or an addition; esp., to abate or deduct; as, to allow a sum for leakage.' Webster's New International Dictionary, 2d Ed., p. 70, def. 5. 'Allowed' in the statute accordingly means granted as a deduction. Deduction is defined as 'that which is deducted; the part taken away; abatement; as a deduction from the yearly rent.' Webster's New International Dictionary, 2d Ed., p. 284, def. 2b. It is the subtrahend in the process of subtraction. Obviously a minuend is necessary to the process. In the case before us the subtrahend is the depreciation

payer, who *has taken* and *been allowed* depreciation deductions at a certain rate consistently over a period of years, later finds it to his advantage to claim that the allowances so made to him were excessive and that the amounts which were in fact 'allowable' were much less. By this time the Government may be barred from collecting the additional taxes which would be due for the prior years upon the strength of the taxpayer's present contentions. The Treasury is obliged to rely very largely upon the good faith and judgment

and the minuend is the taxable income. If the minuend income is absent it follows that there can be no deduction and consequently no allowance within the meaning of the Act.

"The legislative history of the provisions of the Revenue Act of 1932 under consideration supports our view that the word 'allowed' in the Act refers only to depreciation which has been availed of by the taxpayer as an offset to taxable income. In the report of the Committee on Ways and Means of the House of Representatives (House Rep. 708, 72nd Cong., 1st sess., p. 22) upon the portion of the Act now under consideration appears the following (italics ours):

" 'In subparagraph (B), relating to depreciation, etc., for the period since February 28, 1913, the bill requires that adjustment be made to the extent allowed (but not less than the amount allowable) instead of 'by the amount * * * allowable' as in the prior Act. The treasury has frequently encountered cases where a taxpayer, who has taken and been allowed depreciation deductions at a certain rate consistently over a period of years, later finds it to his advantage to claim that the allowances so made to him were excessive and that the amounts which were in fact 'allowable' were much less. By this time the government may be barred from collecting the additional taxes which would be due for the prior years upon the strength of the taxpayer's present contentions. The treasury is obliged to rely very largely upon the good faith and judgment of

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of the taxpayer in the determination of the allowances for depreciation, since these are primarily matters of judgment and are governed by facts particularly within the knowledge of the taxpayers, and the Treasury should not be penalized for having approved the taxpayer's deductions. While the committee does not regard the existing law as countenancing any such inequitable results, it believes the new bill should specifically preclude any such possibility. * * *"

the taxpayer in the determination of the allowances for depreciation, since these are primarily matters of judgment and are governed by facts particularly within the knowledge of the taxpayer, and the treasury should not be penalized for having approved the taxpayer's deductions. While the committee does not regard the existing law as countenancing any such inequitable results, it believes the new bill should specifically preclude any such possibility.'

"Obviously the committee referred to the situation in which a taxpayer, having had the benefit of a larger depreciation deduction from gross income than was properly allowable to him, claims upon the sale of the depreciated property that his sale basis should be increased by deducting only the smaller depreciation properly allowable, thus gaining a double deduction against taxable income. We think it clear that it was to prevent the possibility of such a double deduction that the provisions of the Revenue Act of 1932 which we are considering were enacted. No double benefit can be received where, as in the case before us, the depreciation originally claimed offset no income which would otherwise have been taxable."

Does the Construction of the Word "Allowed" Here Contended for by the Taxpayer Conform to the Theory of Depreciation?

The depreciation charge permitted as a deduction from gross income in determining the taxable income of a taxpayer for any year represents the reduction during the year of the capital assets through wear and tear. The amount of the allowance for depreciation is the sum which should be set aside for the taxable year in order that at the end of the useful life of such assets the aggregate of the sums set aside (with the salvage value) equals the original cost. The theory underlying this

allowance for depreciation is that by using up the depreciable assets a gradual sale is made of them. The depreciation charge in any year is the measure of the cost of the part which has been used up in that year. When the assets are disposed of after years of use, the thing then sold is not the whole thing originally acquired. The amount of the depreciation must be deducted from the original cost of the whole in order to determine the cost of that disposed of in the final sale of the property. See *United States* v. *Ludey, supra.* The application of this theory of depreciation compels a taxpayer to deduct each year from the value of his depreciable property an amount equal to the value of the property actually used up during the year. Thus if a taxpayer has purchased depreciable property at a cost of $100,000.00, the useful life of which property is ten years, he must each year take as a deduction for depreciation $10,000.00. This amount is usually referred to as the *allowable* depreciation and must be deducted each year by the taxpayer regardless as to whether he has taxable income. *Beckridge Corporation* v. *Commissioner of Internal Revenue* (C. C. A. 2d), 129 F. (2d) 318; *Hardwick Realty Co.* v. *Commissioner of Internal Revenue* (C. C. A. 2d), 29 F. (2d) 498. The reason for this equitable and salutary rule is that since the taxpayer each year uses up a portion of the value of his depreciable assets, his income for such year can only be accurately determined if he deducts from his gross income for such year his allowable depreciation. Any other rule would not correctly reflect the taxpayer's income for such year.

The Commissioner of Internal Revenue in this case has consistently urged that this theory of depreciation requires the taxpayer to reduce the basis of its depreciable assets as of December 31, 1937 by not only the *allowable* depreciation for all previous years, but by the

entire amount of depreciation reported by the taxpayer on its income tax returns for such previous years, regardless as to whether such reported depreciation reduced or offset its income in the year in which reported. Obviously the result contended for by the Commissioner does not give effect to the theory of depreciation, but is in direct conflict therewith as it requires the taxpayer to take a smaller deduction for depreciation in one year than another when actually the same use has been made of the depreciable assets each year. If the theory of depreciation is to be given full effect, the taxpayer should be allowed to deduct for depreciation the same amount each year, provided, of course, the use made of the depreciable property is the same each year. It seems clear that it was the purpose of Congress in amending Section 113(b)(1)(B) of the Revenue Act of 1932, supra, to depart from this theory of depreciation only when it is necessary so to do in order to prevent a taxpayer from obtaining a double deduction. Since no double deduction can be obtained in this case the theory of depreciation should be given effect by allowing the taxpayer in the year 1938 to take as a deduction for depreciation an amount equal to the measure of the cost of the depreciable property used up during the year.

The Tax Benefit Rule.

The taxpayer also believes that it is entitled to restore to the value of its depreciable assets as of December 31, 1937 the sum of $31,400.25 under "The Tax Benefit Rule." This Rule stated generally is that where an amount has been deducted by a taxpayer on his return in a prior year and such deduction when taken did not offset taxable income, then no tax benefit arises from the deduction and thus the recovery in a later year of the amount deducted should not be treated as taxable income. This rule has frequently been applied by the courts

which hold that where amounts previously deducted from income for losses, expenses, bad debts and taxes did not effect an offset of taxable income for the year in which deducted, then the recovery of such amounts in subsequent years does not have to be included in gross income in the year of recovery. *Central Loan & Investment Co.* v. *Commissioner of Internal Revenue,* 39 B. T. A. 981; *National Bank of Commerce of Seattle* v. *Commissioner of Internal Revenue,* 115 F. (2d) 875; *Amsco Wire Products Corporation, Transferee,* v. *Commissioner of Internal Revenue,* 44 B. T. A. 717; *American Dental Co.* v. *Commissioner of Internal Revenue,* 44 B. T. A. 425; *Shell Milling Co.* v. *Commissioner of Internal Revenue,* Memo. B. T. A. Docket No. 101415. While the tax benefit rule has received wide approval by the courts, it has not been universally followed. *Helvering* v. *State Planters Bank & Trust Co.* (C. C. A. 4th), 130 F. (2d) 44; *Commissioner of Internal Revenue* v. *United States and International Securities Corporation* (C. C. A. 3d), 130 F. (2d) 894. It is interesting to note, however, that the tax benefit rule now has the sanction of Congress as Section 116 of the Revenue Act of 1942, (which section also amends every prior revenue act) expressly provides for the exclusion of such recoveries from gross income. This section of the Revenue Act of 1942 thus constitutes a legislative reversal of the decisions in the cases of the *State Planters Bank & Trust Company* and *United States and International Securities Corporation.*

Cases Relied Upon by the Respondent in the Lower Courts.

The taxpayer has hereinbefore considered the cases of *United States* v. *Ludey, supra,* and *Hardwick Realty Co.* v. *Commissioner, supra.* The facts in these two cases are very similar to the facts in the case of *Beckridge*

Corporation v. *Commissioner of Internal Revenue* (C. C. A. 2d), 129 F. (2d) 318, and thus all three of these cases will be considered together. These cases hold that upon a sale of property the basis thereof must be reduced by the amount of depreciation which was legally allowable in past years even though no such deduction was claimed on the prior tax returns and no tax advantage would have resulted if it had been so claimed. These cases, it is submitted, are correctly decided and are in accord with the theory of depreciation urged by the taxpayer in this case.

The Commissioner of Internal Revenue in the lower courts has urged that the cases of *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359, 75 L. Ed. 383, and *Burnet* v. *Thompson Oil & Gas Co.*, 283 U. S. 301, 75 L. Ed. 1049, are authority for the proposition that each taxable year must be regarded as an independent unit for income tax purposes. These cases are undoubtedly authority for such proposition. The respondent argues that it is contrary to the spirit of this rule to permit the taxpayer to take a proper deduction for depreciation in the year 1938 because it erroneously reported its depreciation in prior years. It is submitted, however, that the rule that each taxable year must be considered as an independent unit for income tax purposes is not effected by refusing to permit the taxpayer in this case to take as a deduction the depreciation which it actually sustained in the taxable year because in prior years it mistakenly claimed deductions for depreciation in excess of the amounts properly allowable. The proposition here contended for seems to have been approved by this court in the case of *Koshland* v. *Helvering*, 298 U. S. 441, 80 L. Ed. 1268. In that case it was decided that a taxpayer upon a sale or other disposition of his property is entitled to use the correct basis thereof in determining his gain or loss

regardless of how the property may have been treated in prior years.

The cases of *Helvering* v. *State Planters Bank & Trust Co.* (C. C. A. 4th), 180 F. (2d) 44, and *Commissioner of Internal Revenue* v. *United States and International Securities Corp.* (C. C. A. 3d), 180 F. (2d) 894, both deal with the question whether a taxpayer must include in his gross income collections on bad debts previously charged off as worthless when the charge-off did not result in a tax benefit to the taxpayer. These cases were cited and relied upon by the United States Circuit Court of Appeals for the Fourth Circuit in reaching its decision in this case. In view of the fact that Section 116 of the Revenue Act of 1942 constitutes a legislative reversal of the decisions in these cases, it seems unnecessary to discuss such cases further.

CONCLUSION.

The taxpayer submits that the United States Circuit Court of Appeals for the Fourth Circuit was clearly in error in deciding that it is not entitled to restore to the value of its depreciable assets as of December 31, 1937 the sum of $31,400.25 and that, therefore, the judgment of that court should be reversed.

Respectfully submitted,

VIRGINIAN HOTEL CORPORATION OF LYNCHBURG.

By S. V. KEMP AND
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